

## **Brexit Vote: The Populist Voice Has Spoken**

The outcome of the Brexit vote for Britain to leave the EU speaks volumes to the rise in populist voice across many parts of the world. The “keep Britain for the British” message is representative of a growing wave of protectionism, where the middle class is speaking up against lack of wage growth and job loss. Anti-trade, anti-globalization, and immigration are the hot buttons driving sentiment and is reversing the 75 year push for free-trade, open borders, and an integrated financial system.

Slow Growth, the Root Cause: Slower economic growth both domestically and globally means fewer jobs and is the root cause of the growing protectionist movement. If there are fewer jobs to go around, wages stall and the sentiment of ‘we can't allow immigrants to take a job’, is understandable. People are protective of their own job and do not see a promising future; thus protectionism sentiment is well rooted and will be hard to reverse anytime in the near future.

Politics vs Economics: *Without taking political sides on this issue (strongly emphasized),* this wave of populist protectionism is in direct conflict of the efficient allocation of the world's capital and resources. The financial reality is that if we go the route of anti-trade and nationalism, prices will rise and, at least initially, domestic and global growth will be inhibited. For example, if the U.S. wants to slap tariffs on Chinese goods, an imported shirt made in a Chinese factory with labor paid at a rate of \$0.50/hour will now be made in a California factory with labor paid at a rate of \$17.50/hour. This is a perfect example of the conflicting agendas of politics verses pure economics and means that it will take a long time, (months if not years) to sort out. And in countries where the populist have a vote, it will be a key driver.

Market View on Vote: After listening to three web-casts this morning from Neuberger Berman, Nomura Securities, and JPMorgan, and pouring over the market data, here are the key take aways:

- **This is a big event for a small country as the UK only represents 4% of global GDP.** UK annual growth is expected to be reduced by -1 to -2% this year, possibly putting it into a recession. It will take the UK 2yrs to complete the withdrawal process. Thus the immediate impact on the EU growth is minimal but may be larger over time as other member countries may become more embolden to do the same. **Britain has its own currency (Sterling)** and therefore the impact of the withdrawal on the rest of the EU will not be as dramatic as it would be if another country like Germany or Greece left.
- **Outside of Europe, the greatest impact on the global economy is expected to be in Asia, with Japan getting hit the hardest.** Asia's GDP, minus Japan & Australia, is revised down by 0.3% to 5.6%. However, the decline in Japan is expected to be greater because of the currency impact. The further decline in the Euro/appreciation in Yen, make foreign imports from Asia even more expensive.
- **China: Another Yuan devaluation could shock markets.** Even prior to Brexit, the Chinese economy did not appear durable enough to endure its overvalued exchange rate. With this sudden plunge in the exchange rates of Europe, Chinese goods face an even more disadvantageous position on

global markets. Should the Chinese decide to do another significant devaluation, it could be a shock to the markets (like we saw last August).

- **Direct impact on US economy near term is very modest.** The biggest potential impact could be on consumer and investor sentiment which in turn can eventually affect the economy. But between now and the election, more of 'the same' is expected: slow-growth, low inflation, low interest rates, and sluggish productivity. The Fed is now expected not to raise rates this year.
- **Large cap companies will fare better than small cap in the UK.** Many of the large companies in the FTSE 100 Index are global rather than U.K. businesses—80% of the index's revenues come from overseas. This should help insulate them from any domestic downturn and potentially deliver a windfall from the weakened pound. Smaller, more domestically-focused companies are more vulnerable to a fall in consumer demand and higher import costs.
- **US multi-national companies' earnings at risk: Dollar remains key to the direction of earnings and stock prices.** When the dollar rises, earnings fall. After five consecutive quarters of earnings decline in the S&P 500, earnings in the second half of this year were expected to rebound, partly due to a falling dollar and possible pick-up in growth. Now with the Britain vote to leave the EU, both Sterling and the Euro are falling and the US dollar is rising. If this continues, it will become a significant headwind for earnings, and will postpone the recovery until sometime next year.
- **Watch the European Banks:** The European banks are the most visible risk indicator of the state of things in Europe. There are concerns that the global margin calls, due to the plunges in FX rates and oil prices, will cause a potential capital shortage and could prompt a run on the European banks. Of course the ECB would take strong measures to insure order.

Portfolio Strategy: The market is likely constrained to a wide trading range. Expect continued bouts of large price swings and at times 'gapping' price changes. The biggest risk is political uncertainty which will not be resolved any time soon and that will likely keep a ceiling on prices. At the same time, a supportive Fed and positive (but slow) growth will provide a floor.

Portfolio risk was reduced early in the quarter and remains at the lower end of the risk band. Until there is a significant move in the market or more clarity on the political front, the investment strategy will remain the same: emphasis on capital preservation with weighting in defensive and income producing asset classes and sectors.

As always, please contact me with any questions or concerns.

Happy Friday!

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